BEFORE THE PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA

DOCKET NO. 2018-318-E

In the Matter of:	)	
	)	**DIRECT TESTIMONY OF**
Application of Duke Energy Progress, LLC	)	**JOHN L. SULLIVAN, III**
For Adjustments in Electric Rate Schedules and	)	**FOR DUKE ENERGY**
Tariffs	)	**PROGRESS, LLC**

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS, AND POSITION WITH DUKE ENERGY CORPORATION.

A. My name is John L. Sullivan, III. My business address is 550 South Tryon Street, Charlotte, North Carolina, 28202. I am employed by Duke Energy Business Services, LLC ("DEBS") as Director, Corporate Finance and Assistant Treasurer. I am also the Assistant Treasurer of Duke Energy Progress, LLC ("DE Progress" or the "Company"). DEBS provides various administrative and other services to DE Progress and other affiliated companies of Duke Energy Corporation ("Duke Energy").

Q. PLEASE SUMMARIZE YOUR EDUCATION AND PROFESSIONAL QUALIFICATIONS.

A. I received a Bachelor of Arts degree from the University of North Carolina-Chapel Hill in 1995 and an MBA degree from Wake Forest University in 2000.

Q. PLEASE SUMMARIZE YOUR PROFESSIONAL EXPERIENCE.

From 2000 to 2009, I worked in Bank of America's Global Corporate & Investment Banking unit, providing corporate finance, capital markets and strategic advisory services to energy and power clients. In 2009, I joined Duke Energy as a General Manager in the Treasury group. In 2010, I moved to Duke Energy's Corporate Development group where I served as a Director responsible for managing various strategic transactions for the Company's regulated and commercial businesses. In January 2016, I returned to Duke Energy's Treasury department and assumed my current role.

Q. PLEASE DESCRIBE YOUR DUTIES AS DIRECTOR, CORPORATE FINANCE AND ASSISTANT TREASURER.

A. I am responsible for financing the operations of Duke Energy and its subsidiary utilities. This includes the issuance of new debt and equity securities, and obtaining other sources of external funds. My responsibilities also include financial risk management for Duke Energy and its subsidiaries. Additionally, I maintain relationships with Duke Energy's commercial banks, the fixed income investor community and the credit rating agencies.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THIS COMMISSION OR OTHER STATE PUBLIC UTILITY COMMISSIONS?

A. I have not testified before the Public Service Commission of South Carolina but I have filed testimony on behalf of other Duke Energy affiliates, including proceedings before the Ohio and Kentucky commissions.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. My testimony will address DE Progress' financial objectives, capital structure, and cost of capital. I will also discuss the current credit ratings and forecasted capital needs of DE Progress. Throughout my testimony, I will emphasize the importance of DE Progress' continued ability to meet its financial objectives.

Q. PLEASE PROVIDE AN OVERVIEW OF YOUR TESTIMONY.

A. As detailed in my testimony, DE Progress faces substantial capital needs over the next several years. The Company competes for capital in the open market, and must appeal to debt and equity investors to attract the capital it needs. As

Roger Morin, a leading expert on utility finance, indicates, "The … prices of debt capital and equity capital are set by supply and demand, and both are influenced by the relationship between the risk and return expected for those securities and the risks expected from the overall menu of available securities." Morin, Roger A., *Utilities' Cost of Capital* (Public Utilities Reports, Inc. 1984), at 20. Investors have a variety of investment opportunities available to them, and require a return commensurate with the risk they incur. They will invest elsewhere if they feel the expected return provided by a company is inadequate, and lower credit quality weakens a company's attractiveness as an investment opportunity relative to companies with higher credit quality. For this reason, it is critically important that the Company maintain strong investment-grade credit quality, so as to assure its financial strength and flexibility and ensure access to capital on reasonable terms.

The Company is making significant capital investments in order to provide cost effective, safe, reliable, and environmentally-compliant electric service to its customers well into the future. The Company's proposed rate increase will allow the Company to recover prudently incurred costs, to compete in the capital markets for needed capital, and preserve its financial standing with both equity and debt investors as well as the credit rating agencies, to the long-term benefit of customers.

Q. WHAT ARE DE PROGRESS' FINANCIAL OBJECTIVES?

A. Financial strength and access to capital are necessary for DE Progress to provide cost-effective, safe, environmentally-compliant, and reliable service to its customers. The Company at all times seeks to maintain its financial strength and flexibility, including its strong investment-grade credit ratings, ensuring reliable access to capital on reasonable terms. Specific objectives that support financial strength and flexibility include: (a) maintaining at least 53 percent common equity for DE Progress on a financial capitalization basis; (b) ensuring timely recovery of prudently incurred costs; (c) maintaining sufficient cash flows to meet obligations; and (d) maintaining a sufficient return on equity to fairly compensate shareholders for their invested capital. The ability to attract capital (both debt and equity) on reasonable terms is vitally important to the Company and its customers, and each of these specific objectives helps the Company both to maintain its high investment-grade credit ratings and to meet its overall financial objectives.

Q. DO DE PROGRESS' CUSTOMERS BENEFIT FROM THE COMPANY'S STRONG CREDIT RATINGS?

A. Yes. To ensure reliable and cost-effective service, and to fulfill its obligations to serve customers, the Company must continuously plan and execute major capital projects. This is the nature of regulated, capital-intensive industries like electric and gas utilities. The Company must be able to operate and maintain its business without interruption and refinance maturing debt on time, regardless of financial market conditions. The financial markets can experience periods of volatility, and DE Progress must be able to finance its needs throughout such periods. Strong investment-grade credit ratings provide DE Progress with greater access to the capital markets on reasonable terms during such periods of volatility.

Q. WHAT RATEMAKING TREATMENT IS BEING REQUESTED IN THIS PROCEEDING AND HOW WILL THE COMPANY'S FINANCIAL OBJECTIVES BE IMPACTED?

A. As explained by Witnesses Ghartey-Tagoe and Bateman, DE Progress is requesting an overall rate increase of approximately 10.3 percent, equating to an increase in pre-tax revenue requirement of approximately $59 million. The proposed capitalization in this request is comprised of 47 percent debt and 53 percent equity.

In addition, the requested increase reflects, in part, an increase in the Company's cost of equity capital from the level approved by the Commission in the Company's last general rate case. The testimony of Company's Return on Equity ("ROE") Witness, Robert Hevert, indicates that the Company's cost of equity capital is in the range of 10.25 percent to 11.00 percent. Based on his quantitative and qualitative analyses including the risk profile of the Company, Witness Hevert's view is that 10.75 percent is a reasonable and appropriate estimate of the Company's cost of equity capital.

The Company fully supports Witness Hevert's testimony and analysis. However, as a rate mitigation measure, and in recognition that a rate increase may create hardship for some customers, the Company has proposed rates to be set at an ROE of 10.50 percent. This requested ROE is within Witness Hevert's range, but 25 basis points below Witness Hevert's point estimate.

Approval of the Company's request in this case will support its financial objectives by allowing timely recovery of its investments in plant and equipment, providing sufficient cash flows to fund necessary capital expenditures and service debt, and will provide a fair and reasonable return to equity investors.

Q. PLEASE EXPLAIN CREDIT QUALITY AND CREDIT RATINGS, AND HOW THEY ARE DETERMINED.

A. Credit quality (or creditworthiness) is a term used to describe a company's overall financial health and its willingness and ability to repay all financial obligations in full and on time. An assessment of DE Progress' creditworthiness is performed by two major credit rating agencies, Standard & Poor's ("S&P") and Moody's Investors Service ("Moody's"), and results in DE Progress' credit ratings.

Many qualitative and quantitative factors go into this assessment. Qualitative aspects may include DE Progress' regulatory climate, its track record for delivering on its commitments, the strength of its management team, its operating performance, and the strength of its service area. Quantitative measures are primarily based on operating cash flow and focus on the level at which DE Progress maintains debt leverage in relation to its generation of cash and its ability to meet its fixed obligations (interest expense in particular) on the basis of internally-generated cash. The percentage of debt to total capital is another example of a quantitative measure. Creditors and credit rating agencies view both qualitative and quantitative factors in the aggregate when assessing the credit quality of a company.

Q. WHAT IS THE ROLE OF REGULATION IN THE DETERMINATION OF THE FINANCIAL STRENGTH OF A UTILITY COMPANY?

A. Investors, investment analysts and credit rating agencies regard constructive regulation as one of the most important factors in assessing a utility company's financial strength. These stakeholders want to be confident that the Company operates in a stable regulatory environment that will allow the Company to recover prudently incurred costs and earn a reasonable return on investments necessary to meet the demand, reliability, service, and environmental requirements of its customers and service area. Important considerations include the allowed rate of return, the cash quality of earnings, the timely recovery of capital investments, the stability of earnings, and the strength of its capital structure. Positive consideration is also given for utilities operating in states where the regulatory process is streamlined, the time lag in capital investment recovery is minimized through cost recovery mechanisms such as riders and trackers, and outcomes are equitably balanced between customers and investors.

Q. HOW ARE DE PROGRESS' OUTSTANDING SECURITIES CURRENTLY RATED BY THE CREDIT RATING AGENCIES?

A. As of the date of this testimony, DE Progress' outstanding debt is rated as follows:

Rating Agency	S&P	Moody's
Issuer / Corporate Credit Rating	A-	A2
Senior Secured	A	Aa3
Outlook	Stable	Stable

Obligations carrying a credit rating in the "A" category are considered strong, investment-grade securities subject to low credit risk for the investor. "A" rated debt is presumed to be somewhat susceptible to changes in circumstances and economic conditions; however, the debt issuer's capacity to meet its financial commitments is considered strong. By contrast, ratings in the "BBB" category are considered adequate and have less assurance of access to the capital markets in challenging market conditions. (AA and Aa category ratings for S&P and Moody's, respectively, are stronger than A ratings.)

S&P may also modify its ratings with the use of a plus or minus sign to further indicate the relative standing within a major rating category. An "A+" credit rating is at the higher end of the "A" credit rating category and an "A-" is at the lower end of the category. Moody's credit rating assignments use the numbers "1", "2" and "3", with the numbers "1" and "3" analogous to a "+" and "-", respectively. For example, Moody's credit ratings of "A2" and "A3" would be analogous to "A" and "A-" credit ratings at S&P, respectively.

The ratings outlook assesses the potential direction of a long-term credit rating over an intermediate term (typically six months to two years). DE Progress' "Stable" outlook at S&P and Moody's means that those credit ratings are not likely to change at this time, however a change in outlook or rating could occur if the Company experiences a change in its business or financial risk.

Q. WHAT STRENGTHS AND WEAKNESSES HAVE THE CREDIT RATING AGENCIES IDENTIFIED WITH RESPECT TO DE PROGRESS?

A. The rating agencies believe DE Progress operates in a generally constructive regulatory environment that supports long-term credit quality, and also view the Company's position within the Duke Energy corporate family as credit supportive. However, the rating agencies have identified a number of challenges the Company faces in maintaining its credit ratings. In March 2018, Moody's identified several factors that could adversely impact the Company's financial metrics (specifically, cash flow coverage ratios), which, in turn, could affect its ratings.[1]

- Regulatory Lag: Moody's is particularly focused on downward pressure on financial metrics due to regulatory lag, including in the recovery of coal ash basin closure costs.
- Tax Reform: Moody's estimates that federal tax reform will have a negative impact on regulated utilities, due to reduced cash flows, which, in turn, places downward pressure on credit metrics.
- Capital Expenditures: Moody's notes elevated capital expenditures, due to T&D projects and coal ash basin closure costs.

[1] *See* Moody's Investors Service, Credit Opinion, "Duke Energy Progress, LLC – Update to Credit Analysis," March 19, 2018 ("March 2018 DE Progress Report")

S&P identifies similar risks to Duke Energy and DE Progress in its September 2018 research update.[2] While S&P affirmed its stable outlook, it stated DE Progress had higher operational risks associated with nuclear generation and higher environmental risks associated with coal generation. S&P also indicated how DE Progress is expected to have negative discretionary cash flow, increasing the Company's reliance on external funding sources. S&P indicates that it could "lower the ratings on Duke and its subsidiaries, including DEP, by one notch over the next 12 to 24 months if the company's financial performance consistently weakens."[3]

Q. HOW DO THE RATING AGENCIES VIEW THE IMPACT OF TAX REFORM ON UTILITY CREDIT QUALITY?

A. In January 2018, Moody's published a report outlining its initial assessment of the impact of tax reform on the regulated utility sector.[4] In its report, Moody's noted "the legislation was broadly credit positive for corporate cash flows but for regulated investor-owned utilities, which include electric, gas, and water utilities, the effect was the opposite." In addition to outlining the negative impact of tax reform on utilities and the regulatory uncertainties related thereto, Moody's changed the rating outlook of 24 utilities (including Duke Energy Corporation) from "Stable" to "Negative".[5]

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[2] *See* S&P Global Ratings, "Summary: Duke Energy Progress LLC," September 13, 2018 ("September 2018 DE Progress Report")

[3] September 2018 DE Progress Report, p. 3

[4] *See* Moody's Investors Service, Sector Comment, "Tax Reform is Credit Negative for Sector, but Impact Varies by Company," January 24, 2018 ("January 2018 Report")

[5] January 2018 Report, p. 1

In June 2018, Moody's updated its 2019 outlook for the regulated utility sector to "Negative" from "Stable".[6] A key factor in this outlook change was a decline in cash flows. Moody's stated that "the combination of a lower tax rate and the loss of bonus depreciation as a result of the federal Tax Cuts & Job Act (TCJA) in December 2017 means that utilities and their holding companies will lose some of the cash flow contribution from deferred taxes on an ongoing basis."[7] Moody's estimated that since 2010, the cash due to deferred taxes averaged 14 percent of Funds from Operations ("FFO"), which is a measure of cash flow generated by a company's operations, on a consolidated basis.

Of the 24 utilities Moody's placed on "Negative" outlook in January 2018, Duke Energy was the first to have its outlook resolved. In August 2018, Moody's issued a credit opinion restoring Duke Energy's outlook to "Stable".[8] Moody's attributed this to an expectation that Duke Energy will maintain supportive regulatory relationships and highlighted credit supportive rate case outcomes across several regulatory jurisdictions. Moody's also described how Duke Energy's 2018 equity issuance and reduced capital program in response to tax reform helped reduce parent-level debt financing.

[6] *See* Moody's Investors Service, Outlook, "2019 Outlook Shifts to Negative Due to Weaker Cash Flows, Continued High Leverage," June 18, 2018 ("June 2018 Report")
[7] June 2018 Report, p. 2
[8] *See* Moody's Investors Service, Credit Opinion, "Duke Energy Corporation – Update Following Change of Outlook to Stable," August 14, 2018 ("August 2018 DE Corporation Report")

Q. MOODY'S HAS NOT CHANGED DE PROGRESS RATINGS OUTLOOK. DOES THIS MEAN TAX REFORM DOES NOT MATERIALLY IMPACT DE PROGRESS?

A. No. While the Moody's January 2018 Report identifies certain utility issuers whose credit metrics are weaker relative to their current ratings, it does not mean that Moody's will not take action on other utility issuers in the future. If unmitigated, the reduction in cash flows will erode DE Progress' credit metrics. In its June 2018 Report, Moody's included a financial forecast using a peer group of 102 utility operating companies. Moody's forecasted that the reduction in cash flow will cause operating company FFO/Debt metrics to drop "to 20 percent from 24 percent over the next 12-18 months."[9] This is an industry-wide analysis where some issuers will be affected more than others.

Q. HAVE OTHER UTILITY COMMISSIONS TAKEN STEPS TO MITIGATE THE NEGATIVE IMPACTS OF TAX REFORM?

A. Yes. Examples include:

- In North Carolina, the Commission addressed tax reform in its DE Carolinas order. The order implemented the lower federal tax rate (to 21 percent from 35 percent) but also allowed DE Carolinas to delay the giveback of protected and unprotected excess deferred income taxes until the earlier of 3 years or its next base rate case. This will give the NCUC time to evaluate how best to return this value to customers. In its August 2018 DE Corporation Report, Moody's stated, the return could come in the form of accelerated recovery of

[9] June 2018 Report, p. 2

certain expenses, or the avoidance of rate increases. Moody's goes on to state, "We would view these outcomes as credit positive, and we believe the decision will likely set a precedent for similar treatment at Duke Energy Progress."[10]

- In Florida, the Commission ordered Duke Energy Florida to accelerate depreciation of coal assets by $50 million per year. It also granted Duke Energy Florida the ability to utilize the remainder of the customer benefits of a lower tax rate to avoid a rate increase for power restoration costs assicated with Hurricane Irma. In August 2018, Moody's stated that it views "these tax reform related developments as supportive of credit quality."[11]
- The Indiana PUC also issued a credit-supportive order to mitigate the near-term impacts of tax refom. Duke Energy Indiana was authorized a 10-year amortization period of approximately $167 million unprotected excess accumulated deferred income tax. However, the refund to customers is limited to $7 million per year in the first five years, increasing to $35 million per year until the entire deferral amount has been returned to customers. This back-end shaping of the deferral is credit-supportive as it limits the near-term negative impact from lower cash flows and allows the utility more time to prepare for and absorb the higher payback obligation.

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[10] August 2018 DE Corporation Report, p. 4

[11] *See* Moody's Investors Service, Credit Opinion, "Progress Energy, Inc. – Update Following Upgrade to Baa1," August 13, 2018, p. 3 ("August 2018 Progress Energy Report")

- In Georgia, a settlement between Georgia Power and the Commission staff puts off EDIT issues for two years, and increases the equity portion of the utility's equity-to-debt ratio while flowing back to customers the effects of the tax rate decrease. Adjustments to the utility's ROE or equity layer are on the Moody's list of mitigation measures.[12]
- In Alabama, the Commission approved a plan to increase Alabama Power's equity ratio to 55 percent by 2025. It also authorized Alabama Power to offset $30 million of under-recovered fuel costs with its excess deferred tax liability.

Q. WHAT IS DE PROGRESS' PROPOSED CAPITAL STRUCTURE?

A. As mentioned earlier in this testimony, DE Progress' proposed capital structure is 47 percent long-term debt and 53 percent equity. The Company believes this proposed capital structure is optimal for DE Progress, as it introduces an appropriate amount of risk due to leverage while minimizing the weighted average cost of capital to customers. Approval of the proposed capital structure will help DE Progress maintain its credit quality. This level is also consistent with the Company's target credit ratings for DE Progress.

Q. DOES THE ACTUAL FINANCIAL CAPITAL STRUCTURE VARY OVER TIME?

A. Yes, it does. The specific debt/equity ratio will vary over time, depending on a variety of factors, including, among other things, the timing and size of capital investments and payments of large invoices, debt issuances,

[12] January 2018 Report, p. 4

seasonality of earnings, and dividend payments to the parent company. Achieving an approved regulatory capital structure of 47/53 is consistent with the Company's financial objectives and overall plan to maintain its ability to finance operations at rates favorable for customers and DE Progress will manage its capital structure within reasonable range of this base. As of December 31, 2017, DE Progress' capital structure was 46.8 percent long-term debt and 53.2 percent equity.

Q. WHAT IS DE PROGRESS' COST OF EQUITY?

A. Witness Robert B. Hevert, who has separately filed testimony, indicates that the Company's cost of equity is 10.75 percent and the Company supports Mr. Hevert's analysis. However, as indicated previously in my testimony, for rate mitigation purposes, the Company has elected to propose rates incorporating a 10.50 percent ROE.

Q. WHAT ROLE DO EQUITY INVESTORS PLAY IN THE FINANCING OF DE PROGRESS, AND HOW WILL THE OUTCOME OF THIS CASE IMPACT THESE INVESTORS?

A. Equity investors provide the foundation of a company's capitalization by providing significant amounts of capital, for which an appropriate economic return is required. DE Progress compensates equity investors for the risk of their investment by targeting fair and adequate returns, a stable dividend, and earnings growth - these are all necessary to preserve access to equity capital. Returns to equity investors are realized only after all operating expenses and fixed payment obligations (including debt principal and interest) of the business have been paid. Because equity investors are the last to receive surplus earnings and cash flows, their investment involves significantly more risk. For this reason, equity investors require a higher return for their investment. Equity investors expect utilities like DE Progress to recover their prudently incurred costs and earn a fair and reasonable return for their investors. The Company's proposal in this proceeding supports this investor requirement.

Q. WHAT EFFECT DOES CAPITAL STRUCTURE AND RETURN ON EQUITY HAVE ON CREDIT QUALITY?

A. Capital structure and return on equity are important components of credit quality. As mentioned in the previous answer, the greater the equity component of capitalization, the safer the returns are to debt investors, which translates into higher credit quality and lower borrowing costs. In addition, the allowed return on equity is a key component in the generation of earnings and cash flows. An adequate return on equity helps ensure equity investors receive fair compensation for their investment while also helping to protect the interests of debt investors. A strong capital structure and an adequate return on equity provide balance sheet protection and cash flow generation to support high credit quality. High credit quality creates financial flexibility by providing more readily available access to the capital markets on reasonable terms, and ultimately lower debt financing costs.

Q. DO YOU BELIEVE THAT DE PROGRESS' CAPITAL STRUCTURE HAS AN ADEQUATE EQUITY COMPONENT TO ENABLE DE PROGRESS TO ACHIEVE THE COMPANY'S FINANCIAL STRENGTH AND CREDIT QUALITY OBJECTIVES?

A. Yes. DE Progress' equity component, as requested in this case, enables it to maintain current credit ratings and financial strength and flexibility. This level of equity enables the Company to tolerate different business cycles while also providing a cushion to the Company's lenders and bondholders. Like many utilities, DE Progress is in a period of significant capital investment necessary to provide cost-effective, safe, environmentally-compliant, and reliable service to its customers in a time of rising costs, lower load growth and rapidly evolving state and federal requirements. The magnitude of its capital requirements dictates the need for a strong equity component of the Company's capital structure in order to assure access to capital funding at reasonable terms.

Q. WHAT IS DE PROGRESS' AVERAGE COST OF LONG-TERM DEBT?

A. DE Progress' weighted average cost of long-term debt as of December 31, 2017 is 4.06 percent. Over the last several years, DE Progress has been taking advantage of low interest rates, steadily decreasing the weighted average cost of long-term debt as older bonds are replaced with new, lower cost, issuances. More recently, however, borrowing costs have started to trend back up and are expected to continue rising. For example, in October 2018 the 10-year US Treasury rate reached 3.23 percent, a level not seen since 2011. During this same time the 5-year US Treasury reached levels not seen since before the financial crisis of 2008.

Q. WHAT ARE DE PROGRESS' CAPITAL REQUIREMENTS OVER THE NEXT THREE YEARS?

A. DE Progress faces substantial capital needs over the next several years in order to satisfy debt maturities, comply with environmental requirements, refurbish, replace and upgrade aging infrastructure, construct or acquire needed generation resources, strengthen and modernize our energy grid, invest greater amounts in energy efficiency, and to satisfy its debt maturities. The Company's capital requirements for the next three years (2019-2021) are projected to be approximately $7.6 billion. This amount consists of approximately $6.1 billion in projected capital expenditures and approximately $1.5 billion in debt retirements.

Q. HOW WILL DE PROGRESS' CAPITAL REQUIREMENTS BE FUNDED?

A. DE Progress' capital requirements are expected to be funded from internal cash generation, the issuance of debt, and equity funding. It is important to remember that Duke Energy also has dividend obligations to its shareholders. Duke Energy's corporate dividend policy targets a 70 percent area payout ratio, based on adjusted diluted earnings per share, and its operating subsidiaries are expected to mirror this policy over time.

Q. DOES THIS CONCLUDE YOUR PRE-FILED DIRECT TESTIMONY?

A. Yes.